Daily Note

FED MARCHING TO AN EASE

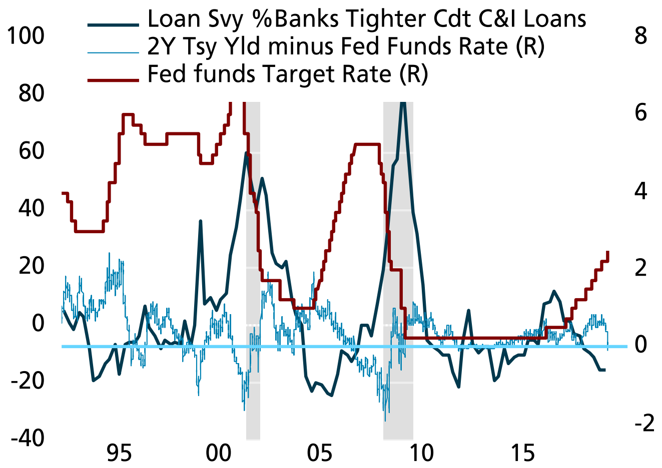
Steven Blitz

- **Asset markets determine economic activity – this is, after all, how monetary policy works**
- **Credit conditions are tightening. A steeper yield curve can reverse this dynamic and that means a Fed ease**
- **Balance sheet reduction not ending, even though the Treasury would like to have its yield subsidy back**

Fed Chairman Powell knows an inverted yield curve at the short end sets off a credit squeeze like the one now getting underway (see chart below). The notion he and other Fed officials have touted of late about asset markets pricing an economy not reflective of reality is disingenuous at best. Asset market pricing determines economic activity. That is how monetary policy works, and it is why the FOMC used zero rates (ZIRP) and QE these past 10 years to distort asset prices to build the recovery. Powell is on a discussion panel this morning with Ben Bernanke and Janet Yellen. After expressing standard boilerplate confidence in the US economy, the question is whether Powell will signal that he hears the yield curve's clarion call for capital to return to safe harbour after a decade of overextended risk positions created by Fed policies.

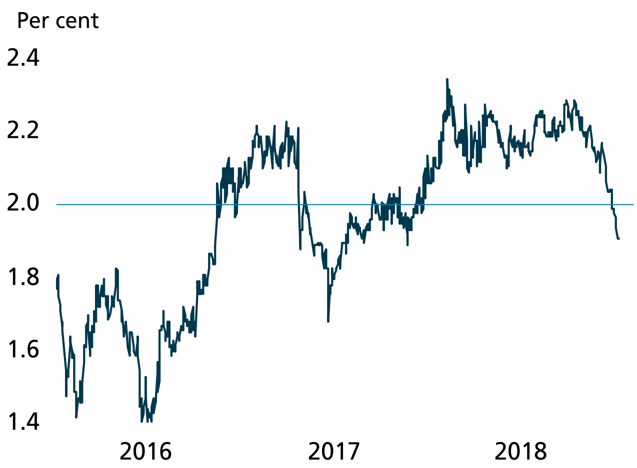
The Fed has to ease to redress the slowing economy. Although the slowdown was planned to a degree, it is now threatening to become much worse as a result of the credit squeeze evidenced by the negative spread between the two-year Treasury yield and the fed funds rate (see 29 August 2018 "US Watch: The Curve to Watch is 2s vs Funds"). Greenspan eased in 1995 during

Cdt Standards for C&I Loans vs 2Y/Funds Sprd



Source: Thomson Reuters Datastream, TS Lombard

US 5y5y forward breakeven inflation rate



Source: Thomson Reuters Datastream, TS Lombard somewhat similar circumstances to great effect. Curves turned back positive and the great 1990s expansion was underway (see chart above). Rates were held constant until the Asian debt crisis intervened.

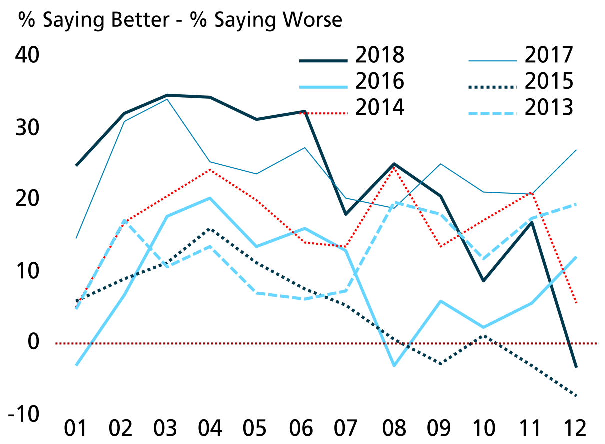
The question for now is when Powell eases. We think it will be in March at the latest. Markets and events overseas may yet not give him the latitude to wait, but he will try jawboning his way to mid-March as best he can to avoid earning the "Powell Put" moniker. The Fed's tactic to date has been the Yellen 2016 playbook, which it tried in December, i.e. lowering term yields by lowering policy guidance to give interest-sensitive sectors a boost. This does not work when cash equivalents is a viable alternative asset, which wasn't the case in early 2016 when the funds rate was only 50bp. Flattening the curve by lowering forward guidance in the current yield environment only accelerates capital flows to cash and the constraint on credit. A steeper curve reverses the squeeze -- either the inflation premium comes back into yields (see chart above) or front-end yields need to drop faster, meaning a total ease of perhaps 50bp.

The Fed will keep reducing its balance sheet unless the economy slips into recession and needs lower real term yields to recover. The Fed's focus is to shrinking its balance sheet and the demands it has placed on them. Carping that balance sheet reduction is a loss of market liquidity is misplaced. Liquidity is not being destroyed. Less reserves at the Fed means banks hold more liquid assets directly, but regulatory constraints determine what they hold. These constraints do mean the Fed's yield subsidy to the Treasury is gone – which is felt more with the doubling of the deficit increasing auction sizes across the curve. The Fed, though, still feels more comfortable lowering the funds rate than getting back to monetising the debt.

The Fed insists on data dependence over market pricing to determine their next move, yet the economic data are leaning in the direction of an ease. We saw this yesterday in the ISM manufacturing survey (see charts below), mortgage applications for purchase and initial unemployment claims. The ISM report was particularly interesting because of the highlighted comments: tariffs and trade are having a clear, definable negative impact on activity whereas credit issues weren't noted - yet.

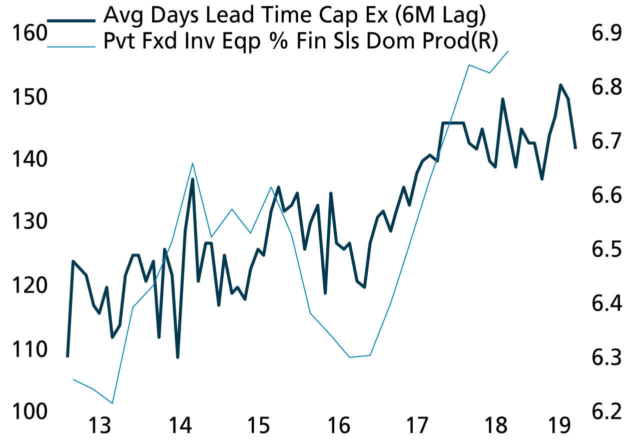
If the Fed chooses to wait too long to ease, however, recession probabilities will rise sharply. Credit crunches do that. Normalising the short end of the yield curve was never going to be easy, quick or painless. The Fed always has too much confidence that the model result prevails. We think Powell is savvy enough to read the markets, ignore the Fed staff's view and ease by March at the latest.

ISM Manuf -- Net New Orders (NSA)



Source: Thomson Reuters Datastream, TS Lombard

ISM Data Implies Weakening CAPEX in GDP --



Source: Thomson Reuters Datastream, TS Lombard